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In the Supreme Court of the United States

OCTOBER TERM, 1928

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

AMERICAN CODE COMPANY, INCORPORATED

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT, AND BRIEF IN SUPPORT THEREOF

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PETITION

The Attorney General, on behalf of the Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the decree of the United States Circuit Court of Appeals for the Second Circuit entered in the above case on January 21, 1929 (R. 19), reversing the decision of the United States Board of Tax Appeals (R. 10).

STATEMENT

The question presented is whether a loss, suffered by respondent through an adverse judgment should be deducted in the year in which the cause of action

arose or in that in which the cause was finally determined.

The findings of fact made by the Board of Tax Appeals are as follows (R. 8–9):

The taxpayer is a New York corporation, organized in the year 1914 in the Borough of Manhattan of the city of New York.

On January 3, 1919, the taxpayer entered into a contract of employment with one Cosmo Farquhar for a term to begin on January 3, 1919, and to end on February 1, 1937, the compensation of the employee to be a commission based upon the sales made in the taxpayer's business.

On May 1, 1919, the taxpayer discharged the said Cosmo Farquhar from its employ.

In July, 1919, Farquhar began action against the taxpayer in the Supreme Court of New York County to recover commissions due him for April, 1919, alleged to be $100, and for breach of the contract of employment, claiming damages for such breach in the amount of $100,000. The taxpayer defended such action on the ground that Farquhar had previously breached his contract of employment and that his discharge was justified by reason of his failure to perform his duties. This action was reached for trial in January, 1922, and resulted in a verdict by the jury against the taxpayer and an award of damages in favor of Farquhar for breach of contract in the sum of $21,019.19.

The taxpayer appealed to the appellate division of the Supreme Court, State of New York, which court, on June 2, 1922, affirmed the judgment. Taxpayer then appealed to the Court of Appeals of the State of New York, in which court the judgment was again affirmed on the 16th day of January, 1923.

The taxpayer paid the amount of said judgment in January, 1923.

The taxpayer kept its books and made its income-tax returns on the accrual basis.

The taxpayer, at the close of the year 1919, set up on its books as a reserve for the breach of the contract of employment the amount of $14,764.79, such amount having been computed at the rates of commission and on the basis specified in the said contract. At the close of the year 1920 this reserve was increased on the taxpayer's books by $32,994.09 to conform to the amount of its liability computed on the same basis, and at the close of the year 1921, judgment having been rendered early in January, 1922, before the books had been closed for 1921, the reserves so set up on its books, amounting to $47,458.88, were adjusted to the liability as fixed by the judgment against the taxpayer in the sum of $21,019.19.

On October 28, 1919, the taxpayer wrote the Commissioner that its employee was suing to recover commissions due under the contract and made a

written request of the Commissioner of Internal Revenue for permission to deduct from taxpayer's income-tax return for 1919 the accumulated commissions which would be due on December 31, 1919, under the contract, which request was denied on November 11, 1919.

The taxpayer, in compliance with said ruling by the Commissioner, did not deduct in its 1919 income-tax return the amount set up as a reserve for 1919 commissions, but on January 21, 1925, its 1919 return being then in process of audit by the Income Tax Bureau, the taxpayer filed a claim for refund with the Commissioner of Internal Revenue, in which it claimed the right to deduct from its income for the year 1919 the amount of its liability for breach of the said contract of employment, the sum of $21,019.19, and that by reason of such deduction it was entitled to a refund of income tax paid for 1919 in the sum of $9,364.85.

The Commissioner, in a notice dated September 17, 1925, rejected such claim for refund and asserted a deficiency in tax against the taxpayer for 1919 of $122.91.

The decision of the United States Board of Tax Appeals affirmed the determination of the Commissioner. Upon respondent's appeal to the Circuit Court of Appeals for the Second Circuit, that court reversed the decision of the Board of Tax Appeals and allowed the respondent to take the deduction in the year 1919.

SPECIFICATION OF ERRORS

The Circuit Court of Appeals erred:

I. In reversing the order of redetermination of the Board of Tax Appeals.

II. In holding that the item in question was properly deductible from gross income for the year 1919 within the provisions of Section 234 (a) of the Revenue Act of 1918.

REASONS FOR GRANTING THE WRIT

I. The decision of the Circuit Court of Appeals is in conflict with the decision of the United States Court of Claims in the case of *Malleable Iron Range Co.* v. *United States,* 62 C. Cls. 425, and with the decision of that court in the same case rendered after remand by this Court, 65 C. Cls. 441.

II. The decision of the Circuit Court of Appeals is also in conflict with the principles set forth by this Court in *United States* v. *Anderson,* 269 U. S. 422, and *Lewellyn* v. *Elec. Reduction Co.,* 275 U. S. 243.

III. The decision of the Circuit Court of Appeals unsettles the established practice of the Bureau of Internal Revenue as to the time when certain deductions can be taken. The issue here is identical with that of the case of *Malleable Iron Range Co.* v. *United States, supra,* in which certiorari was allowed, but in which this Court remanded to the Court of Claims for further findings of fact without hearing or decision on the merits.

It is desirable, therefore, that a writ of certiorari issue in this case that the decision of this Court may establish a settled rule for the guidance of the courts and the Treasury Department.

Wherefore, it is respectfully submitted that this petition for a writ of certiorari to review the judgment of the Circuit Court of Appeals for the Second Circuit should be granted.

WILLIAM D. MITCHELL,
Attorney General.

April, 1929.

BRIEF IN SUPPORT OF THE PETITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals is reported in 10 B. T. A. 476. (R. 9.) The opinion of the Circuit Court of Appeals has not been reported, but will be found at page 14 of the record.

JURISDICTION

The judgment of the Circuit Court of Appeals sought to be reviewed was entered January 21, 1929. (R. 19.) Jurisdiction to issue the writ is found in the provisions of Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925. The appeal to the Board of Tax Appeals was filed prior to the enactment of the Revenue Act of 1926, and decision by the Board was subsequent to the passage of that Act. (R. 1.) This case, therefore, involves the question of the validity of the provisions of law for appeals from the Board of Tax Appeals to the courts raised in the cases of *Old Colony Trust Company* v. *Commissioner of Internal Revenue,* No. 130, and *Commissioner of Internal Revenue* v. *Old Colony Railroad,* No. 407. As that question has not been determined and is considered in the briefs submitted by the Govern-

ment in those two cases, no further discussion here is deemed necessary.

QUESTIONS PRESENTED

May respondent take a deduction in 1919, under Section 234 (a) of the Revenue Act of 1918, for a loss resulting from its breach of a contract in that year but only determined by final decision of an appellate court in 1923?

STATUTES INVOLVED

Revenue Act of 1918, c. 18, 40 Stat. 1057:

> SEC. 234 (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> (1) All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, and including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity;
>
> * * * * *
>
> (4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;
>
> * * * * *

SEC. 212. (b) The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 200 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

If a taxpayer changes his accounting period from fiscal year to calendar year, from calendar year to fiscal year, or from one fiscal year to another, the net income shall, with the approval of the Commissioner, be computed on the basis of such new accounting period, subject to the provisions of section 226.

SEC. 232. That in the case of a corporation subject to the tax imposed by section 230 the term "net income" means the gross income as defined in section 233 less the deductions allowed by section 234, and the net income shall be computed on the same basis as is provided in subdivision (b) of section 212 or in section 226.

STATEMENT

The facts are sufficiently stated in the petition for certiorari.

ARGUMENT

The respondent herein discharged an employee, with whom it had a long-term contract of employment, in the year 1919. In that same year this employee brought action against the respondent alleging a breach of contract. The respondent denied liability, asserting that the employee had breached the contract.

In the year 1919 respondent, who kept its books on the accrual basis, set up a reserve to take care of a possible judgment against it. This reserve was measured by the amount the employee would have earned had he continued in respondent's employ. During the year 1920 this reserve was increased in the same manner. In January, 1922, judgment was rendered against respondent and the reserve, as of the end of the year 1921, was adjusted in accordance therewith. In January, 1923, this judgment was affirmed by the Court of Appeals of the State of New York, and paid.

In 1925 the respondent claimed a refund for the year 1919. This claim was predicated upon its asserted right to deduct in that year the amount of the judgment which was rendered against it in 1922 and paid in 1923. The Circuit Court of Appeals for the Second Circuit allowed the deduction in the earlier year, basing its opinion largely upon the

theory that damages are suffered when the contract is broken, and are assessed as of that date.

This decision is in direct conflict with the decision of the Court of Claims in *Malleable Iron Range Co.* v. *United States,* 62 C. Cls. 425. In that case the petitioner asked that it be allowed to deduct in 1918 a reserve set up to take care of a judgment rendered against it in that year, but from which it had appealed. In 1919 petitioner increased the reserve to meet a possible increase in the judgment. In 1920 the Circuit Court of Appeals increased the judgment and, as increased, affirmed it. The Court of Claims held that "when the amount in question is in litigation it can not be determined until the litigation is ended" (p. 432), and refused to allow the deduction in the earlier years. This Court allowed certiorari (273 U. S. 688) but remanded the case for further findings of fact, without passing on the merits (273 U. S. 674). Upon remand (65 C. Cls. 441) it was developed that in 1918 the petitioner had deposited certain funds with a trust company to abide the decision of the Circuit Court of Appeals, and, as to this amount over which petitioner had lost control, deduction was allowed. During the year 1919 petitioner had not parted with any further sums of money and the Court of Claims reaffirmed its earlier decision as to that year. See also *Consolidated Tea Co.* v. *Bowers* (S. D. N. Y.), 19 F. (2d) 382; and *contra, Becker Bros.* v. *United States* (C. C. A. 2nd), 7 F. (2d) 3.

This latter case may be reconciled with the second *Malleable Iron Range Co. case, supra,* as the taxpayer, who was the judgment debtor, had actually parted with the amount of the judgment in the earlier years.

It is also believed that while the facts in this case distinguish it from the cases of *United States* v. *Anderson,* 269 U. S. 422, and *Lewellyn* v. *Elec. Reduction Co.,* 275 U. S. 243, the decision here conflicts with the principles there laid down.

The first of these cases involved the right of a taxpayer, who kept books on an accrual basis, to deduct from income of the year 1917 taxes due for the year 1916, but not payable until the latter year. The Revenue Act of 1916 became effective on September 8, 1916. It appears that the respondent, Anderson, set up on his books a monthly reserve to take care of these taxes, beginning with the month in which the Act was passed. This Court, in holding that the deduction must be taken in the earlier year, said (p. 441):

> In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it.

It is apparent that there had been no determination of either of these conditions precedent to an accrual in the instant case. Nothing had here

occurred to "fix the amount" or to "determine the liability." It is entirely true, as stated by the Circuit Court of Appeals for the Second Circuit, that damages are suffered and assessed as of the time of the breach, but at that time there is only a controverted and speculative liability. This liability requires the subsequent action of jury and court to convert it into such a definite or ascertainable loss as the taxing statutes contemplate.

In the *Elec. Reduction Co. case, supra,* the respondent contracted for the purchase of certain ore in the year 1918 and accepted and paid a draft therefor. It never received the ore and instituted actions to recover the money paid. In 1922 litigation was terminated without collection and respondent asked a deduction for the loss in the year 1918. This Court concluded that the loss was sustained in the year in which the litigation was terminated. In that case court action and its termination merely proved worthlessness, whereas here the loss, itself, was contingent on court action. There the question did not arise as to the relationship of the time of assessing damages with the time of accruing tax-free reserves.

The position of the Commissioner in the instant case is directly supported by Article 111 of Regulations 45, which, in effect, is overturned by this decision. This article is analogous to Treasury Decision 2433, which was approved by this Court in *United States* v. *Anderson, supra.* In principle it

has been consistently followed by the Bureau of Internal Revenue. (See Article 111 of Regulations 62, and Article 112 of Regulations 65 and 69.)

In view of the effect of this decision upon a settled departmental interpretation and of the confusion resulting from a direct conflict between this decision and the decision of the Court of Claims in the *Malleable Iron Range Company cases*, it is desirable that a writ of certiorari issue in order that a determination be made for the guidance of the courts and of the Treasury Department.

Respectfully submitted.

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APRIL, 1929.

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